

Letter of Findings: 04-20120167
Sales and Use Tax
For Tax Year 2009

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ISSUE

I. Sales and Use Tax – Imposition – Manufacturing Exemptions.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-2.5-5-30; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); [45 IAC 2.2-5-12](#); [45 IAC 2.2-5-70](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Rhoades v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Indiana Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dep't of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1995); Webster's II New Riverside University Dictionary (1st ed. 1988).

Taxpayer protests the assessment of use tax on the purchase of tangible personal property.

STATEMENT OF FACTS

Taxpayer is an Indiana company which manufactures and sells various types of landscaping products, including mulch. In 2011, the Indiana Department of Revenue ("Department") conducted a sales/use tax audit for 2009 and 2010 tax years. Pursuant to the audit, the Department determined that Taxpayer did not pay sales tax or use tax for tangible personal property, which it purchased and used for its business activities. As a result, the Department's audit assessed Taxpayer additional use tax and interest.

Taxpayer only protested the Department's assessment on a portable transfer conveyor ("Conveyor") claiming that the Conveyor was exempt from sales/use tax. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition – Manufacturing Exemptions.

DISCUSSION

The Department's audit determined that Taxpayer purchased the Conveyor without paying sales/use tax and, therefore, assessed Taxpayer additional use tax. Taxpayer, to the contrary, claimed that it was entitled to the manufacturing exemption outlined in IC § 6-2.5-5.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called the "use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoades v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Id. A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). A statute which provides a tax exemption, however, is strictly construed against the taxpayer. *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101. Thus, in applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The exemption to which Taxpayer aspires like all tax exemption provisions, is strictly construed against exemption from the tax. *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); *Mynsberge v. Indiana Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999). Therefore, in order for Taxpayer to prevail on the issue it raises, Taxpayer must demonstrate that the initial assessment was "wrong" and that it is instead entitled to a sales tax exemption which is "strictly construed" in favor of taxation.

IC § 6-2.5-5-3(b) provides:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it **for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added).**

IC § 6-2.5-5-5.1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

Thus, the Legislature granted Indiana manufacturers a sales tax exemption for certain purchases, which are for "direct use in direct production, manufacture... of other tangible personal property." In enacting the exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacturer purchases for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that meets the 'double direct' test." *Mumma Bros. Drilling Co. v. Indiana Dep't of State Revenue*, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). For the capital equipment "in order to be exempt, must (1) be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of tangible personal property." *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 525 (Ind. 1983). "The test for directness requires the equipment to have an 'immediate link with the product being produced.'" *Id.* Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. *General Motors Corp. v. Indiana Dep't. of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991). The application of Indiana's double-direct manufacturing exemption often varies based on a determination of when a taxpayer's manufacturing process is considered to have begun and ended.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). Machinery, tools, and equipment are directly used in the direct production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. *Id.* An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), example 1.

[45 IAC 2.2-5-8\(k\)](#) describes direct production as the performance of an integrated series of operations which transform the matter into a form, composition or character different from that in which it was acquired and substantially transform the property into a different and distinct product.

The exemption for direct use in direct production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [45 IAC 2.2-5-8 through 45 IAC 2.2-5-10] with respect to tangible personal property used directly in the following activities: pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

The exemption for direct consumption in production is further explained at 45 IAC 2.2-5-12, in part, as follows:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation [45 IAC 2.2] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

45 IAC 2.2-5-8(d) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

45 IAC 2.2-5-8(f) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

45 IAC 2.2-5-8(g) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit.

The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property. (Emphasis added).

Additionally, 45 IAC 2.2-5-8 (j) provides:

Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax.

This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; **safety or fire prevention equipment which does not have an immediate effect on the product**; space heating; **ventilation and cooling for general temperature control**; illumination; heating equipment for general temperature control; and shipping and loading. **(Emphasis added).**

IC § 6-2.5-5-30 further states:

Sales of tangible personal property are exempt from the state gross retail tax if:

(1) the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure **predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards**; and

(2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

The portion of the sales price of tangible personal property which is exempt from state gross retail and use taxes under this section equals the product of: (A) the total sales price; multiplied by (B) one hundred percent (100 [percent]). **(Emphasis added).**

45 IAC 2.2-5-70, in relevant part, further states:

(a) The state gross retail tax does not apply to sales of tangible personal property which **constitutes**, is incorporated into, or is consumed in the operation of, **a device**, facility, or structure **predominately used** and acquired **for the purpose of complying with any state, local or federal environmental quality [sic] statutes, regulations or standards; and the person acquiring the property is engaged in the business of manufacturing**, processing, refining, mining, or agriculture.

(b) Definitions. (1) Consumed as used in this regulation [\[45 IAC 2.2\]](#) means the dissipation or expenditure by combustion, use or application, and does not mean or include the obsolescence, discarding, disuse, depreciation, damage, wear or breakage of tools, machinery, devices or furnishings.

(2) Incorporated as used in this regulation [\[45 IAC 2.2\]](#) means the material must be physically combined into and become a component of the environmental quality device, facility, or structure. The material must constitute [sic] a material or integral part of the finished product. **(Emphasis added)**.

The word "comply" is defined as:

1. To act in accord with another request, command, rule, or wish. 2. Obs. To be courteous or obedient.

Webster's II New Riverside University Dictionary 291 (1st ed. 1988).

In *Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue*, 650 N.E.2d 1223 (Ind. Tax Ct. 1995), the taxpayer who rented clean textiles claimed that it was entitled to an exemption for its purchases of EPA compliance items (waste water treatment equipment) pursuant to IC § 6-2.5-5-30. As a general rule to interpret the Indiana tax statutes, the Tax Court in *Mechanics Laundry* stated:

Where words are used at one place in an Act, they will be construed as used in the same sense at other places in the Act, unless the clear context of the statute requires a different meaning. Further, when considering two or more statutes that relate to the same general subject matter, the court will read those statutes in pari materia and construe them together so as to produce a harmonious system.

The environmental quality exemption is part of the same act in which the equipment, consumption, and incorporation exemptions are found. In addition, the language of the environmental quality exemption is nearly identical to the language used in the equipment, consumption, and incorporation exemptions.... The environmental quality exemption must, therefore, be construed in harmony with the equipment, consumption, and incorporation exemptions. Accordingly, the term "processing," as it is used in the environmental quality exemption, has meaning only to the extent that goods or items of other tangible personal property are produced. *Mechanics Laundry*, 650 N.E.2d at 1232. (Internal citations omitted).

The court in *Mechanics Laundry* found that both the taxpayer and the Department stipulated that the taxpayer was "engaged in the production or manufacture of logos and name tags." *Id.* Based on the evidence presented, however, the court in *Mechanics Laundry* determined that the taxpayer operated "its waste water treatment equipment in connection with the laundering of soiled textiles, but not in connection with the production of logos and names tags." *Id.* Thus, the court in *Mechanics Laundry* concluded that the taxpayer, *Mechanics Laundry & Supply, Inc.*, "is not entitled to receive the exemption for its purchases of EPA compliance items." *Id.*

In this instance, Taxpayer asserted that it uses the Conveyor to facilitate its manufacturing process. Taxpayer stated, in relevant part, that:

[It] accepts tree trimmings and brush [sic] from tree removal companies and landscapers and purchases raw bark from saw mills and uses these materials to produce mulch. These products are mixed together and loaded into a tub grinder. **The grinder grinds the tree trimmings and bark. The grinder feeds the materials onto a screener which screens out any unacceptable materials. Once the product is screened, it is stacked into large pile approximately 25 feet high by a portable conveyor. The materials then "cook" in the piles for a period of 3-6 months in which microorganisms work to create a finish product. (Emphasis added).**

At the hearing, Taxpayer further explained that it purchased and used the Conveyor to be in compliance with the Indiana Fire Code. Thus, Taxpayer maintained that its use of the Conveyor qualified for the manufacturing exemptions. To support its protest, Taxpayer submitted additional documentation, including a photo and a video clip to demonstrate its use of the Conveyor. Taxpayer also provided a copy of a letter ("Notice to Correct Violations") from the local fire department and a copy of a letter from the Office of the State Building's Commissioner, which approved Taxpayer's application for variances concerning the Indiana Fire Code.

Upon reviewing Taxpayer's documentation, the Department must respectfully disagree. First, the Department's audit noted that Taxpayer's "manufacturing process begins with the grinding of tree trimmings and the tree bark. Colorants can be added to the mulch during the grinding process to produce black, brown or red color mulch." Taxpayer's manufacturing process thus ends when its product comes out of the grinder and is screened. At that point, the mulch becomes saleable. Taxpayer asserts that it needs to "cook" ("approximately 130 to 150 degrees Fahrenheit") the mulch "for a period of 3-6 months in which microorganisms work to create a finish product." However, Taxpayer's documentation failed to support its assertion. Thus, based on the documentation presented, Taxpayer used the Conveyor to rotate or restack the mulch is, at best, post-production because the conveyor did not have an immediate effect on the mulch being produced. Taxpayer's use of the Conveyor at this point is simply to maintain its inventory prior to the sales.

Additionally, Taxpayer explained that, prior to its purchase/use of the Conveyor, it used to drive a

loader/bulldozer to compact the pile to control the size of the pile, which created spontaneous combustion and caused fires. After several fires occurred and the fire department was called to put out the fires, Taxpayer purchased the Conveyor to be in compliance with the local fire department's request. However, the local fire department's letter addressed the issue of Taxpayer's "storage of mulch," not the Taxpayer's production. Moreover, Taxpayer is not required to use the Conveyor; rather, the letter referencing the Indiana Fire Code required that Taxpayer control the size of the piles, have certain portable fire extinguishers, and have an emergency plan. Furthermore, this letter was issued in late 2002 and Taxpayer did not purchase the Conveyor until 2009. Thus, the Department is not persuaded by Taxpayer's assertion that it purchased/used the Conveyor for the purpose of being in compliance with the Indiana Fire Code.

Even if, assuming that Taxpayer purchased the Conveyor to be in compliance with the Indiana Fire Code, the Conveyor is used to control/maintain the size of the pile (storage of the mulch) prior to sale and to prevent spontaneous combustion, namely "fire prevention." Pursuant to [45 IAC 2.2-5-8\(j\)](#), "fire prevention equipment which does not have an immediate effect on the product" is subject sales/use tax. Additionally, Taxpayer did not refer to any environmental quality statutes, regulations, or standards to support its protest. Thus, based on the documentation presented, Taxpayer has not shown that the Conveyor was "used and acquired for the purpose of complying with any state, local or federal environmental [quality] statutes, regulations or standards" as required by IC § 6-2.5-5-30. Pursuant to [45 IAC 2.2-5-8\(g\)](#), "[t]he fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property has an immediate effect upon the article being produced."

In short, given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden. Since Taxpayer did not pay sales tax at the time of the purchase, use tax is properly imposed.

FINDING

Taxpayer's protest is respectfully denied.

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